THE WALL STREET JOURNAL.
The Wall Street Journal, July 28, 2018

China Is Losing the Trade War With Trump

It's like a drinking contest: You harm yourself and hope your opponent isn't able to withstand as much.

By Donald L. Luskin

One thing came through loud and clear in President Trump's press conference Wednesday with European Commission President Jean-Claude Juncker. When they announced an alliance against third parties' "unfair trading practices," they didn't even have to mention China by name for listeners to know who their target was. Cooperation between the U.S. and EU will squeeze China's protectionist model, and even before this agreement, there's been evidence that China is already running up the white flag.

Yes, China is acting tough in one sense, quickly imposing tariffs in retaliation for those enacted by the Trump administration. But while U.S. stocks approach all-time highs and the dollar grows stronger, Chinese stocks are in a bear market, down 25% since January. The yuan had its worst single month ever in June, and is well on its way to a repeat this month. Chinese corporate bonds have defaulted at a record rate in the past six months, yet this week China unveiled a new stimulus program designed to encourage even more corporate borrowing.

That's probably why Yi Gang, a governor of the People's Bank of China, took the extraordinary step of channeling Herbert Hoover, saying in a statement this month that "the fundamentals of China's economy are sound." And it's why Sun Guofeng, head of the PBOC's financial research institute, said, China "will not make the yuan's exchange rate a tool to cope with trade conflicts."

Weakening one's currency is a standard weapon in trade wars, and one that China has often been accused of using—including in a tweet by Mr. Trump last week. Devaluation would be even more dangerous in this case because of China's power to dump the $1.4 trillion in U.S. Treasury securities it holds. But by denying its intention to plunge the yuan, China has disarmed itself voluntarily. This was no act of noble pacifism; it had to be done. Devaluing the currency would risk scaring investors away, an existential threat to an emerging economy. For China, whose state-capitalism model has so far never produced a recession, such capital flight might expose previously hidden economic weaknesses.

These weaknesses accumulate without the market discipline that occasional recessions impose. The fragility of China's economy can be seen in its growth rate, which is slowing despite rising financial leverage, and in its overinvestment in commodities and real estate. The escalating trade war with the U.S. could tip China into the unknown territory of recession—and then capital flight could push it into a financial crash and depression. That would create mass joblessness in an economy that has never recorded unemployment higher than 4.3%. With that scenario in mind, the Chinese government must be wondering whether it has enough riot police.

The risk of capital flight is real. The last time China let the yuan weaken—a slide that began in early 2014 and was punctuated in mid-2015 by the abandonment of the dollar peg in favor of a

basket of currencies—the Chinese ended up losing almost $1 trillion in foreign reserves, which they have yet to recover. Now the sharp weakening of the yuan shows some degree of capital flight again is under way.

No wonder that, despite tough talk from some quarters, the PBOC disarmed itself voluntarily to avoid further capital flight. The bank also is already offering to reimburse local firms for tariffs on imported U.S. goods. What's more, China has put out a yard sign for international investors by announcing unilateral easing of foreign-ownership restrictions in some industries.

China is beginning to realize that trade war isn't really war. It's more like a drinking contest at a fraternity: the game is less inflicting harm on your opponent than inflicting it on yourself, turn by turn. In trade wars, nations impose burdensome import tariffs on themselves in the hope that they'll be able to stomach the pain longer than their competitor.

Why play such a game? Because a carefully chosen act of self-harm can be an investment toward a worthy goal. For example, President Reagan's arms race against the Soviet Union in the 1980s was in some sense a costly self-imposed tax. But it turned out the U.S. could bear the burden better than the Soviets could—Uncle Sam eventually out-drank the Russian bear and won the Cold War.

The U.S. will win the trade war with China in the same way. The PBOC's statements show that the Chinese understand they are too vulnerable to take very many more drinks. The only question is what they will be willing to offer Mr. Trump to get him to take yes for an answer. No wonder Beijing has ordered its state-influenced media to stop demonizing Mr. Trump—officials are desperate to minimize the pain when President Xi Jinping has to cut the inevitable deal.

The drinking-contest metaphor takes us only so far. The wonderful thing about reciprocal trade is that it is a positive-sum game in which all contestants are made better off. If the conflict forces China to accept more foreign investors and goods, comply with World Trade Organization rules, and respect foreign intellectual property, it may feel it has lost but will in fact be better off. With this openness, both economic and political, China could spur a decadeslong second wave of growth that would bring hundreds of millions still living in rural poverty into glittering new cities.

It took Nixon to go to China and show it the way to the 20th century. Now, through the unlikely method of trade war, Donald Trump is ushering China into the 21st century.

Mr. Luskin is chief investment officer at Trend Macrolytics LLC.